

BiH Economic Update

**1999 - Second Quarter
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Preface

This Quarterly Economic Update summarizes key economic indicators for Bosnia and Herzegovina, and analyzes their trends. The sources of statistical information are the Federation and the Republika Srpska (RS) Statistical Institutes, the EC-funded Customs and Fiscal Assistance Office (CAFAO), the Central Bank of Bosnia Herzegovina (CBBH), Federal Institute for Development Programming, RS Customs Department, IMF (Direction of Trade Statistics), World Bank and incidental data sources.

Data should be used with caution and interpreted carefully. Important statistical series are missing due to the lack of resources necessary for data collection and surveys. The existing series suffer from serious coverage gaps, as well as methodological and reporting gaps. Furthermore, statistical reports are not user-friendly.

Gross domestic product (GDP) estimates are just that; they cannot be calculated with any degree of accuracy since neither production, income, nor expenditures are fully covered. In general, the real-sector data underreport the size of the economy, due to the lack of data on the “shadow economy.” At the same time, capital and labor incomes are underreported, even in registered businesses; and household consumption is difficult to estimate, as no household budget surveys have been carried out, and foreign trade is underreported.

I. Recent Economic Trends

Is the BiH economy running out of steam? After four years of double-digit (real) growth in gross domestic product (GDP), driven mainly by donor-fueled physical reconstruction and economic reactivation operations, growth is expected to return to single-digit figures, perhaps as early as in 2001. Implementation of the post-war Priority Reconstruction Program will ensure continuing capital inflow during the next 3 to 4 years. For the Program to generate the high-level GDP growth rates observed in recent years, however, capital inflows would have to escalate at a rate much higher than expected. Furthermore, in the absence of significant sectoral and enterprise restructuring efforts in BiH, the recent Kosovo conflict (i.e., the NATO/Federal Republic of Yugoslavia - FRY war) would have negative impacts on the performance of not only BiH, but also the regional economy.

Industrial production continued to advance in the first quarter of 1999, compared to the 1998 first quarter (Q1) increase, by about 10%, in both the Federation and in the RS. During Q1, construction activities and electricity generation progressed significantly in the RS.

In the **Federation**, however, industrial production almost stagnated in April, falling in May to virtually return to the level observed in May 1998. This slow down is corroborated by the observed in the decrease in the year-to-year electricity production, goods transported by road, tax revenues, imports (April), virtually flat money supply growth, and zero or negative price inflation. In the **Federation**, the industrial sub-sectors having registered the weakest performance are mining, textiles/wearing apparel, manufacturing pulp/paper products, fabricated metal products (excluding machinery) and transport equipment. The NATO/FRY conflict appears to have only a temporary setback in the Federation, as official Federation unemployment has not moved significantly, net wages continued to grow, and excise revenues on imported oil products increased by 14 % in May. Equally significant is that the loan recipients of the USAID Business Development Program (BDP) continued to perform well throughout the first five months of 1999, in terms of both sales growth and receivables; and although the gross margin were low, no negative trend was observed.

According to preliminary estimates, the situation is gloomier in the **RS**. Industrial production fell significantly in April and May, due primarily to the NATO/FRY conflict.. The downturn in industrial production was significant: a drop of 25.4% in April and another fall of 3.9% in May. Industrial Production for the first five months of 1999, however, is up by only 3.7% compared to the same period in 1998¹. Electricity production in May was just 2% higher than in May 1998. In the **RS**, the industrial sub-sectors having experienced the heaviest falls are: food processing, footwear, textile yarn and fabrics, wood processing, chemicals, machinery and transport equipment and non-ferrous metals. Total tax revenues in Q1-1999 fell by one third compared to Q4-1998. During the period January to April, imports into the RS fell by 14%. In particular, imports from the FRY were halved, but this was, in part, compensated for by an increase of imports from Hungary, Slovenia and other countries. The heavy dependence of the RS economy on the FRY has caused a significant spillover effect of the Kosovo campaign on the RS. The fact that the impact of the NATO/FRY conflict on the Federation economy has been limited is an indication of its lesser dependence on the FRY, of stronger internal dynamics, and of the relatively low inter-entity trade.

¹ That Industrial Production did grow marginally (first five months of 1999) is due in essence to the fact that the RS Institute of Statistics reported a dramatic fall in Industrial Production for the month of May 1998.

Regarding the last point, the Federal Institute of Statistics reported that for the month of May 1999, only KM 9.4 million worth of goods were traded between the entities (KM 7 million of Federation sales to the RS, and, KM 2.4 million of RS sales to the Federation). While it is widely believed that these figures underreport the real level of trade between the entities, they nevertheless suggest that recorded inter-entity trade accounted for less than 5% of Federation imports during the month of May 1999.

Table 1: Latest Economic Trends in the Federation

Category	Measurement	1998	month to month	year to year
Industrial Production	Index	23.8%	-3.5% (May)	1% (May)
Construction activity	Effective hours worked	17.5%	21% (Apr)	11.1% (Apr)
Electricity production	index (Fed); MWH (RS)	13.6%	-11.7% (May)	-34% (May)
Goods transported by road	ton-km	21.4%	0.9% (Apr)	-20.6% (Apr)
Forestry production	m3	19.8%	5.5% (Apr)	18.4% (Apr)
Retail price index	Index	5.1%	0% (May)	-2.5% (May)
Net wages	KM	23.8%	2.8% (Apr)	15.8% (Apr)
Net wages	KM (absolute figures)	329 (av.)	376 (Apr)	
Employment	Number	395,445 (av.)	407,179 (Apr)	
Unemployment	Number	240,100 (av.)	262,273 (Apr)	
Imports (Value : USD) (1)			-20.1% (*)	3% (**)
Imports (Value : KM) (2)			27.2% (May)	33.1% (May)
Import excise on oil products	KM	12.4%	14.3% (May)	10.8% (May)
Tax revenue	KM		-19.4% (*)	-7.3% (**)

Notes:

(*) Q1-99 compared to Q4-98

(**) Q1-99 compared to Q1-98

(1) Source = Federation Institute of Statistics

(2) Source = CAFAO

Table 2: Latest Economic Trends in the RS

Category	Measurement	1998	month to month	year to year
Industrial Production	Index	23.5%	-25 % (Apr)	-12.1 % (Apr)
Construction activity	Effective hours worked	34.9%	42.8 % (Mar)	29.2 % (Mar)
Electricity production	index (Fed); MWH (RS)	N/A.	-29.2 % (May)	2 % (May)
Goods transported by road	ton-km	20.8%	16.6 % (Apr)	-13.1 % (Apr)
Forestry production	m3	-4.8%	-0.6 % (Apr)	26.1 % (Apr)
Retail price index	Index	37.9%	1.3 % (May)	N/A.
Net wages	KM	61.9%	1 % (Apr)	55.3 % (Apr)
Net wages	KM (absolute figures)	141 (av.)	200 (Apr)	
Employment	Number		250,000 (Jan)	
Unemployment	Number	142,834 (av.)	145,250 (Mar)	
Imports (Value : USD) (1)				
Imports (Value : KM) (2)				
Import excise on oil products	KM		4.8 % (May)	206 % (March)
Tax revenue	KM		-32.4 % (*)	-19.1 % (**)

Notes:

(*) Q1-99 compared to Q4-98

(**) Q1-99 compared to Q1-98

Table 3: Latest Trends in Money Supply and Trade in BiH

Category	Unit	1998	month to month	Year to year
Broad Money (M2) (*)	KM		1.2% (Mar)	29.5% (Mar)
Money (M1)(*)	KM		0.3% (Mar)	26.5% (Mar)
Imports (**)	USD	5.5%		15.4% (***)
Exports (**)	USD	32%		22.2% (***)

Notes:

(*) Source is Central Bank

(**) Source is IMF Direction of Trade Statistics (excludes FRY data)

(***) Q4-98 compared to Q4-97

II. National Income and Economic Activity

A. National Income

With an annual GDP per capita of about US\$ 1,000, one half of the pre-war level, BiH belongs to the league of lower middle-income countries.

- In 1990, the secondary sector accounted for 45% of the BiH GDP; whereas agriculture, fishery and forestry contributed about 10.8% to GDP. This composition was almost identical to the one observed in the Republic of Korea (1989), even though the latter country featured a GDP per capita of at least twice the level achieved by BiH.
- By 1995, in the Federation, the share of the secondary sector had dropped to 27% (34% in the RS) whereas the share of the primary sector had risen to 23% and 30 %, in the Federation and RS, respectively. Clearly, BiH fell into the league of lower-income economies.
- The share of General Government in GDP was 15.6% in 1990. Currently, however, the share of General Government in GDP is about 18-20 %, in the Federation and around 15% in the RS.²

By all standards, BiH is an exceptional country in terms of donor generosity. The estimated Current Account deficit for 1998 reached US\$ 1.1 to 1.2 billion, whereas the Balance of Trade deficit exceeded US\$ 1.7 billion (1998)³. Foreign aid⁴ to BiH amounted to US\$ 1.173 billion (1998).⁵ Assuming a population of 3.9 million, **per capita aid is estimated at about US\$ 300 (1998)**, much higher than what developing countries generally receive in foreign aid.

The Current Account (CA) deficit (*before official transfers*) amounts to 35% of GDP, reflecting the impact of the civil war in BiH, and an indication that the country continues to live beyond its means.⁶ Under normal conditions in developing countries, Current Account deficits do not usually exceed 10 to 15% during any period of time. Only lower-income, war-ridden countries like Somalia and Mozambique in the 1980s did experience CA deficits exceeding the BiH record.

Whether or not large amounts of foreign aid are beneficial to a country is open for debate. Cross-country evidence points to a substitution effect between foreign aid and domestic savings efforts. Past experience suggest that, in general, countries receiving large amounts of foreign aid (on a per capita basis) did not attract large amounts of foreign direct investment

² It should be pointed out that the public sector plays a role larger than what its share in GDP would suggest. In fact, whereas General Government does not generate more than 20 % of GDP, total government expenditures, including Social Security, amounted to over 60 % of GDP in 1998 (Federation).

³ For an alternative estimate of the Balance of Trade deficit, see also chapter-3 on Foreign Trade.

⁴ Current official transfers + reconstruction assistance + exceptional financing.

⁵ Data retrieved from the "1996-1998 Lessons and Accomplishments : Review of the Priority Reconstruction Program and Looking Ahead Towards Sustainable Economic Development (A Report Prepared for the May 1999 Donors Conference).

⁶ According to the same source, consumption expenditures (1998) amounted to 99% of GDP whereas investment expenditure represented 38 % of GDP.

(on a per capita basis). Whereas a causal link between the two is not obvious, the fact is that foreign aid in the 70s, and to a lesser extent in the 80s, has been often granted to countries characterized by significant policy distortions and low *economic freedom*, a factor that **does** explain low attractiveness for/to foreign investment (Table 4). Countries with virtually *no or very low* economic freedom attract foreign investment inflows on an average US\$ 9 per capita, while those with somewhat *more* Economic Freedom attract US\$ 22-55 per capita, and high economic freedom countries attract in excess of US\$ 282 per capita of foreign direct investment (FDI).⁷

Table 4: Aid and Foreign Investment

Country	aid per capita (\$)	FDI per capita (\$)
Bangladesh	16	0.2
Egypt	31	10.6
Ivory Coast	35	12.3
Tanzania	39	2.8
Kenya	41	3.1
Mozambique	49	0
Mali	57	3.9
Somalia	72	0
El Salvador	87	4.1
Mauritania	102	3

Notes:

* foreign aid (per capita) is calculated for a typical year in the 1980s

* FDI per capita is calculated for the 1990s

* Sources are World Bank, IMF and own calculations

⁷ The concept of Index of economic freedom was obtained from Heritage Foundation publication. Results can be accessed also on the Internet (www.heritage.org). The 1999 edition of the *Index* includes 161 countries. According to the results, the *Index* squeezes BiH the 155th position, between Iran and Somalia, just ahead of Iraq, Libya, Cuba and North Korea, and just behind Myanmar, Rwanda, Angola and Congo (former Zaire), and 58 places behind Cambodia. A recent paper published by the USAID-chaired Industry Task Force ("Constraints to doing business in Bosnia and Herzegovina: an enterprise survey", April 1999), using the same methodology, places BiH in 104th position, close to Russia (106th) and Romania (95th).

Table 5: GDP

Legal Entity	Unit	1995	1996	1997	1998	1999
BiH						
<i>Nominal GDP</i>	million KM	2,719-2,873	4,189-4,276	5,803-6,134	6,900-6,837	7935
<i>Nominal GDP per capita</i>	KM	798	1,164	1,612	1,917	
<i>Real GDP growth</i>	%	33%	28-50 %	15-30 %	20 %	13-20 %
<i>Current Account deficit</i>	% of GDP	9.6-10.2 %	26.9-27.2 %	30.6-38.8 %	25.5-29.4 %	
Federation						
<i>Nominal GDP</i>	million KM	1,962	3,049	4,189	5,000	
<i>Nominal GDP per capita</i>	KM	892	1,386	1,904	2,273	
RS						
<i>Nominal GDP</i>	million KM	637	760	1,614	1,944	
<i>Nominal GDP per capita</i>	KM	651	814	1,153	1,389	

Notes:

- 1998 : estimate
- Sources : World Bank

B. Economic Activity

Table 6 and accompanied graphs present the latest trends of economic activity in the Federation and the RS. The table compares GDP growth and growth in the Index of Industrial Production (IP) in the 1996-98 period. It shows that in 1998, a one-percent growth in the IP-index coincided with approximately 0.8% growth in GDP. Considering that the results have been relatively disappointing regarding industrial production in the Federation and RS, it should not be surprising that most economists now estimate that GDP growth is likely to be in the single-digits for 1999 (about 6% in the Federation and below 5% in the RS), even if growth in the second half of 1999 returns to the performance observed in the second half of last year.

Table 6: GDP and Industrial Production

Entity		1996	1997	1998
FEDERATION				
<i>per capita GDP-growth (in KM)</i>	%	55	37	19
<i>Industrial Production growth</i>	%	88	36	24
RS				
<i>per capita GDP-growth (in KM)</i>	%	25	42	20
<i>Industrial Production growth</i>	%	39	27	24

Sources:

- * GDP : Economic Brief for Bosnia and Herzegovina (World Bank; November 1998) and EBRD
- * Industrial Production : RS and Federation Statistical Institutes

The eight graphs shown on the following pages present:

- Index of Industrial Production
- Construction Activity
- Electric Power Industry
- Goods Transport by Road
- Food Processing (RS) and Trade (in food products/Federation)
- Forestry Production
- Import Excises on oil products
- Performance of USAID Business Finance Clients

for the Federation and RS.

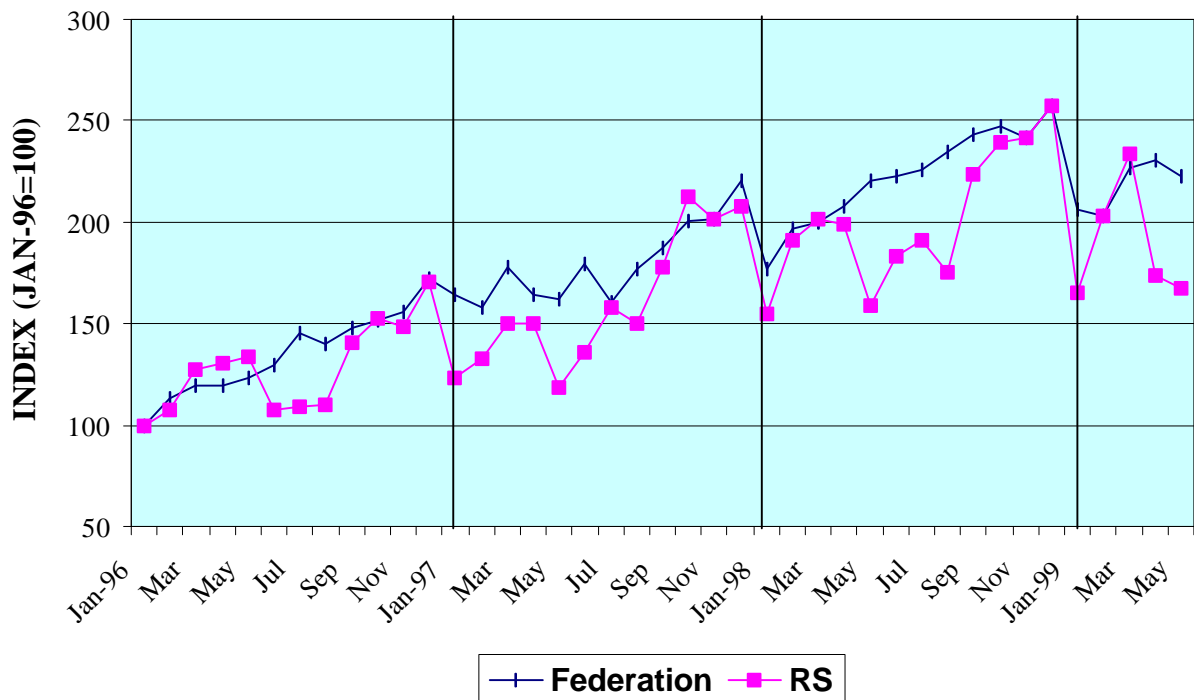
All indicators for which data are available and include the months of April and May suggest that growth in both the Federation and the RS was at best flat (the exception being food trade in the Federation). The effect of the Kosovo crisis is definitely reflected in these indicators. We should note that: (a) import excise revenues started to recover in March (in both entities), perhaps as a result of better collection efforts, and (b) the USAID Business Finance (BF) borrowers (most of whom are private businesses) improved their sales, gross margin and receivables performance.

That said, it should be pointed out that corporate performance has not been uniform. For example, an estimated 11% of businesses have their accounts blocked because of unpaid obligations. According to the Federal Development Planning Institute (Sarajevo), 6,669 businesses registered losses in 1998 (Federation). Total losses amounted to KM 734 million, of which private businesses accounted for only 11.5%. Interestingly, 16 companies accounted for 55% of all losses; among them the Railways BiH, Elektroprivreda BiH (Sarajevo), Coal Mine Tuzla, Sarajevo-Gas, Kakanj Coal Mine, Railway Zenica as well as three hotels in Neum. As for registered profits, these amounted to KM 430 million, of which 58.4% were private businesses'.

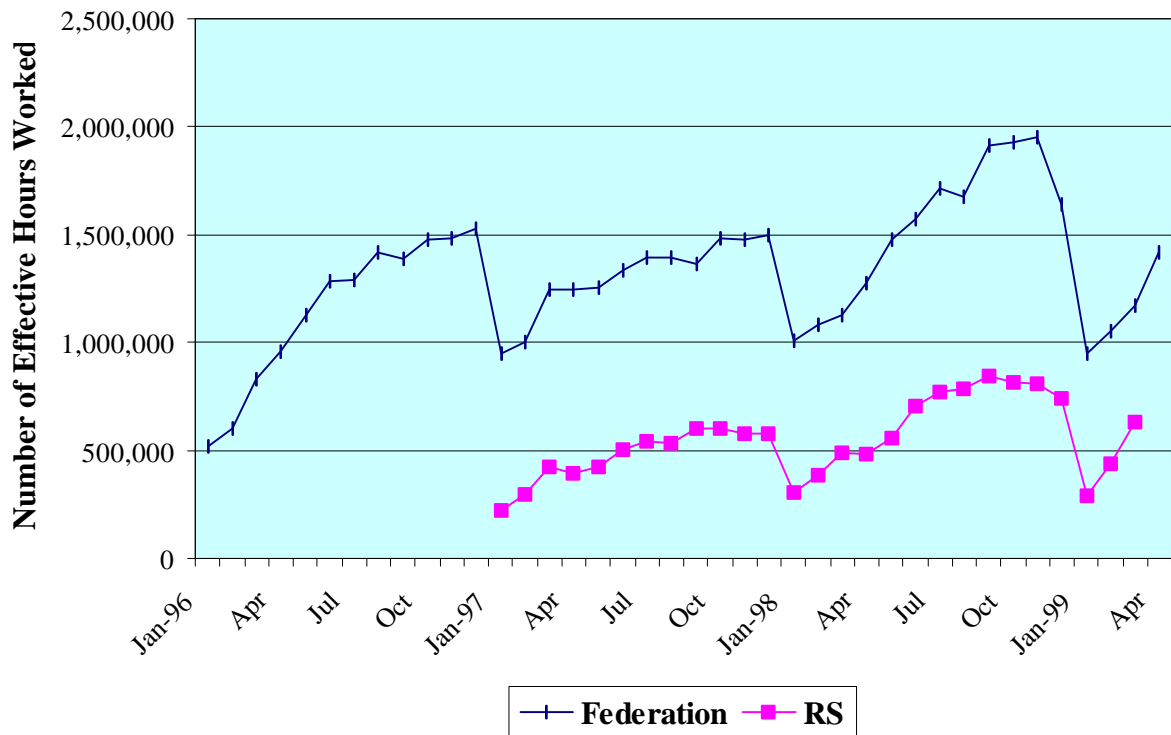
C. BiH Social Indicators

Paradoxically, BiH's social indicators before the 1992-95 civil war and still today, are closer to those levels achieved by countries in the higher middle-income category (e.g. Greece), even with the indicators of higher-income countries. For example, infant mortality in BiH 12.7 per 1000 live births in 1997, pupil/teacher ratio was 15.4 in primary education (1995-1996). Before the war, life expectancy at birth was 72 years (1989), the adult illiteracy rate was 12% (1991) and declining enrollment in tertiary education was 10.4% of the relevant age group (1991).

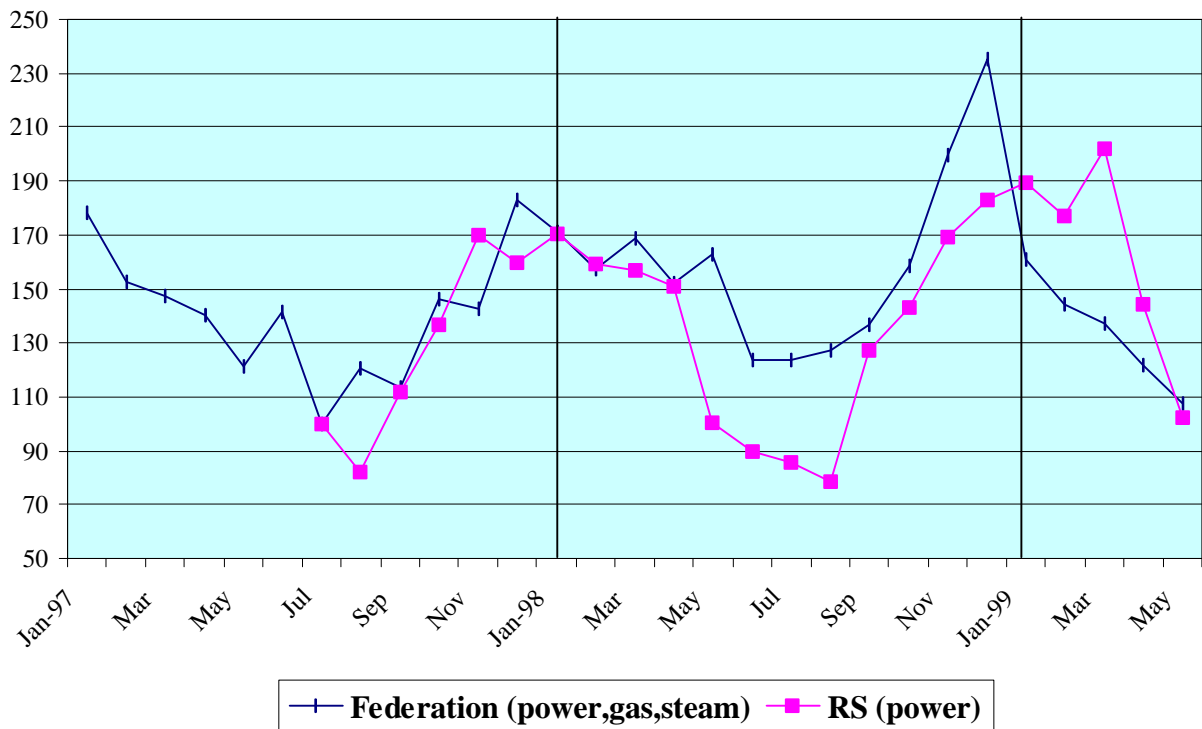
INDEX OF INDUSTRIAL PRODUCTION



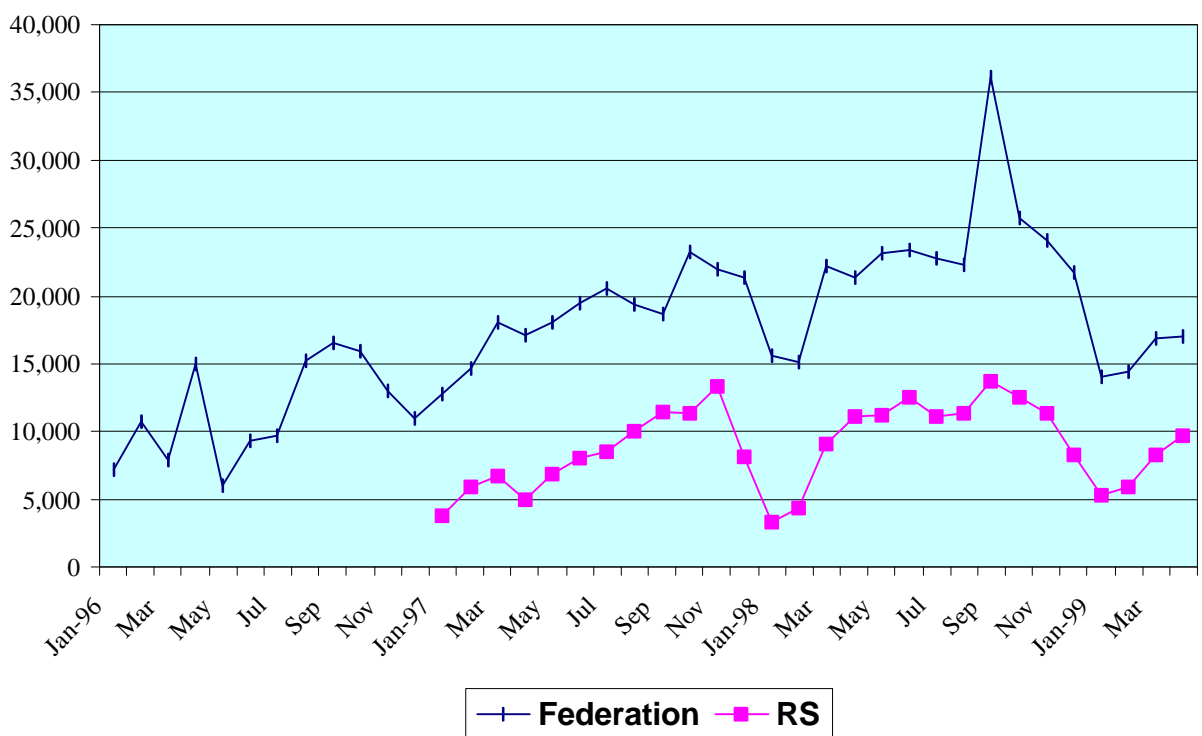
CONSTRUCTION ACTIVITY



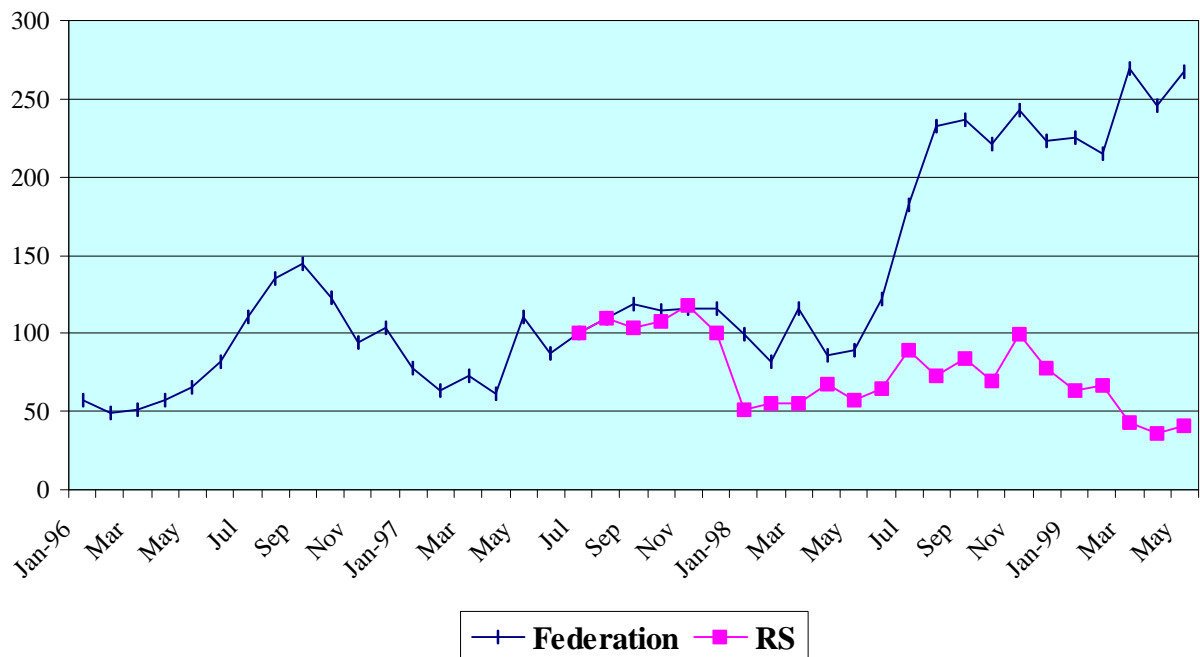
ELECTRIC POWER INDUSTRY



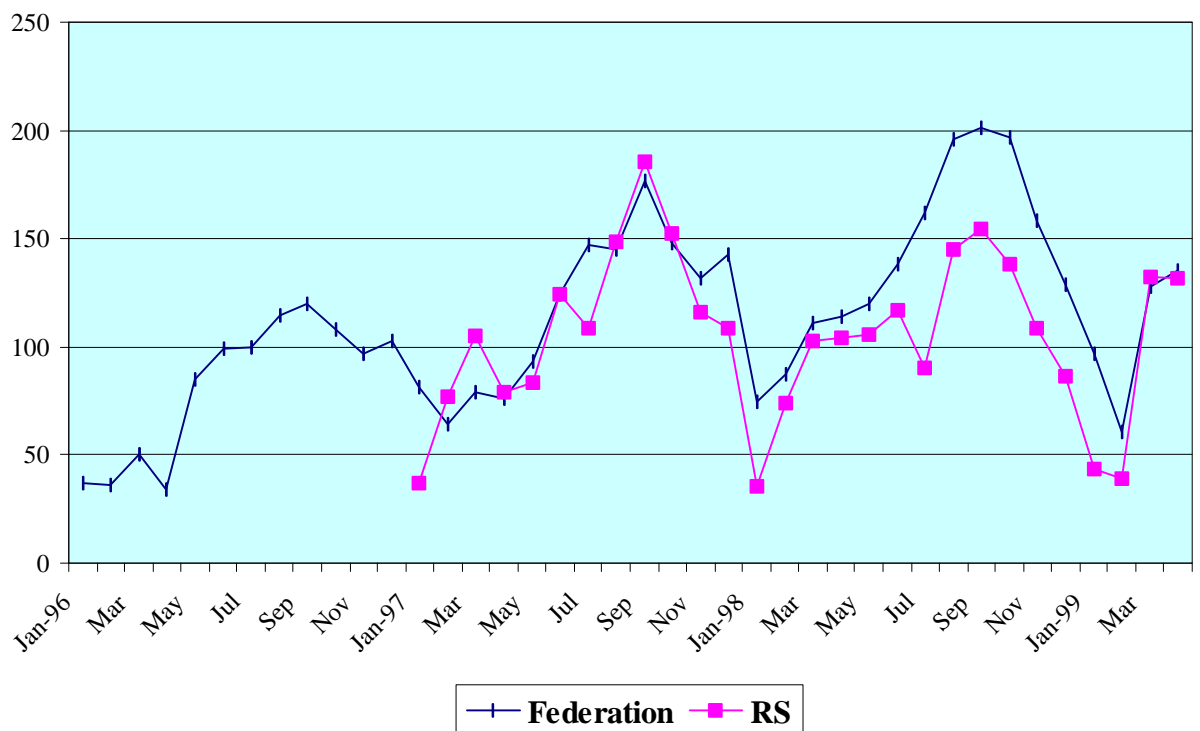
GOODS TRANSPORT BY ROAD



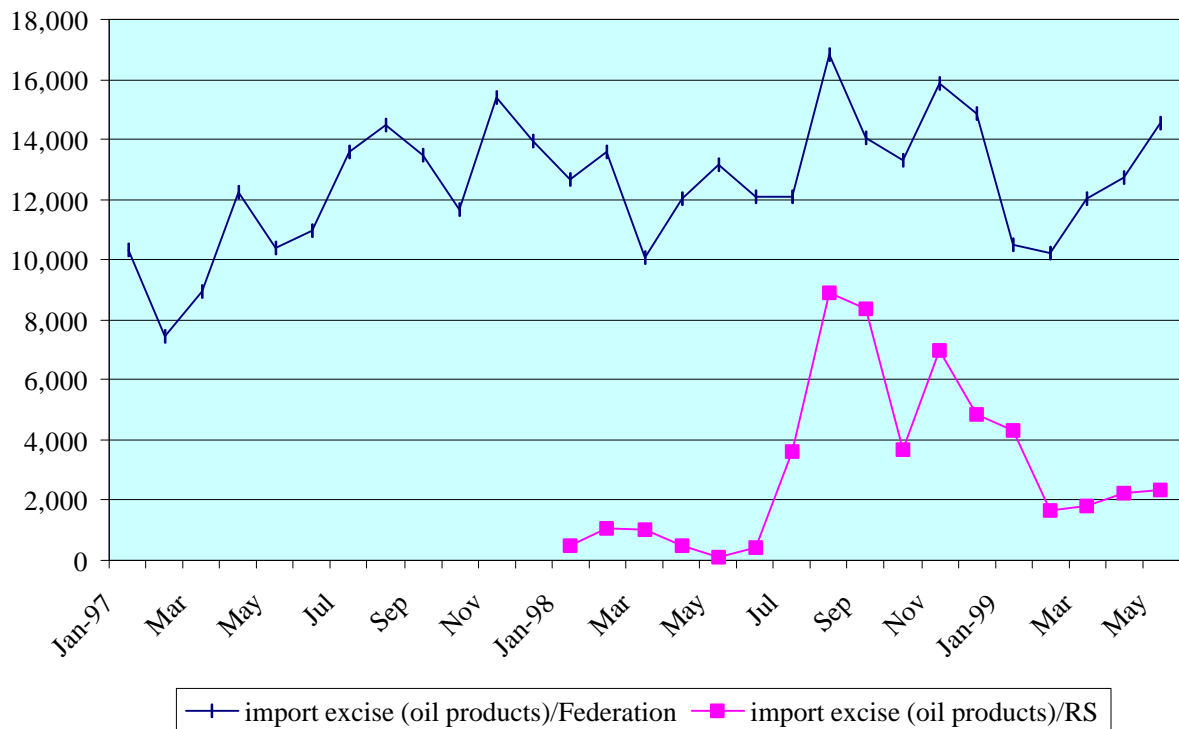
FOOD PROCESSING (RS) & TRADE IN FOOD (FEDERATION)



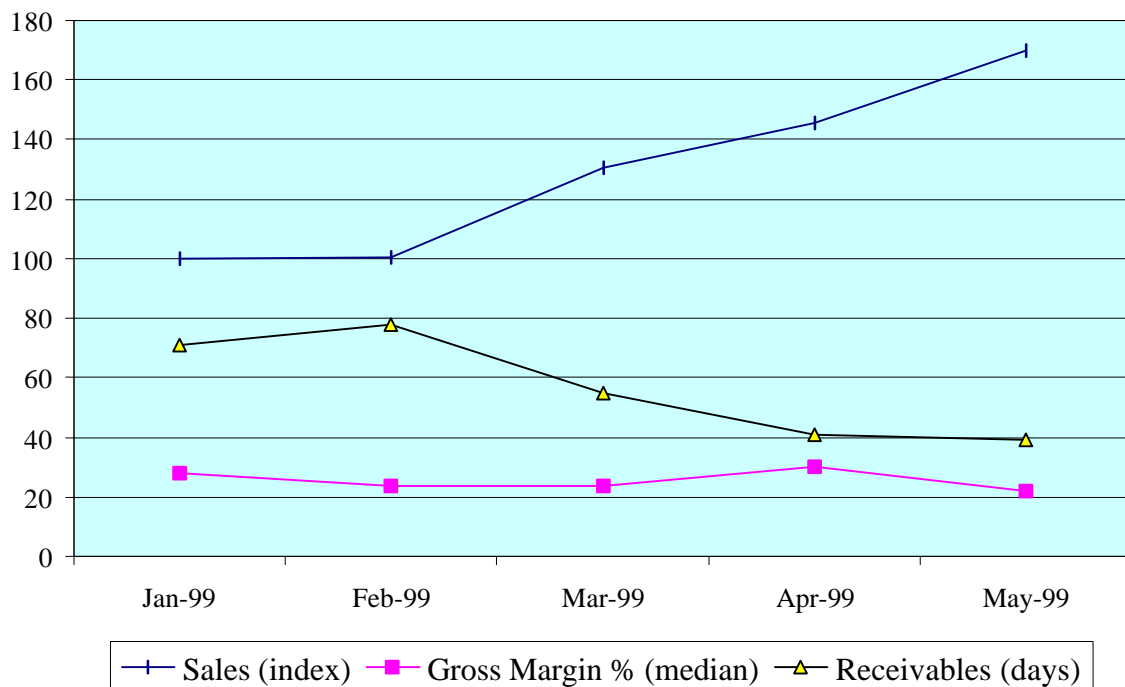
FORESTRY PRODUCTION



IMPORT EXCISES ON OIL PRODUCTS



PERFORMANCE OF BUSINESS FINANCE CLIENTS (LOCATION : FEDERATION)



III. Foreign Trade

Accurate measurement of BiH trade flows is one of the most difficult among all BiH statistical measurements. The RS Statistical Institute does not publish official data on trade flows – though these data are available from the Customs Administration, and the Federal Institute for Statistics has serious difficulties in collecting data.⁸ Other than the generally incomplete and lagging data from the Federation Institute of Statistics, there are two sources of trade statistics: CAFAO's monthly reports and the IMF Direction of Trade Statistics (DOTS).

Official Federal Institute for Statistics data are based on reports from customs houses in the case of imports and from enterprises for exports. CAFAO estimates the value of trade flows using data on receipts of the 1% customs evidencing charge. Both sources are incomplete but the CAFAO data are considered to be more accurate, and timely. The official statistics seriously underestimate imports (e.g. by as much as 60% in Q4-98, and by 26% in Q1-99).

The IMF uses trade reports from BiH's trading partners to estimate imports and exports. The advantage of this method is that a picture is drawn about total BiH imports and exports. The weakness is that trade with the FRY is not included, which is a serious gap since the RS, at least until the Kosovo crisis, had significant trading relations with the FRY. As a result, for 1998 the DOTS probably underestimated imports by US\$ 475 million, and exports by US\$ 217 million. In other words, using DOTS as the starting point and adjusting for the estimated BiH-FRY trade, total imports would have been worth US\$ 2,983 million and exports could have been US\$ 716 million in 1998. Thus, we estimate the 1998 Balance of Trade deficit to be in the neighborhood of US\$ 2,267 million,⁹ significantly higher than either the World Bank or IMF estimates (and those reported by EBRD).^{10 11} Assuming these estimates are somewhat accurate, then the 'true' Balance of Trade deficit in 1998 was as high as 58% of GDP whereas the openness of the economy (measured by total foreign trade divided by GDP) reached 95% (Table10).

As for short-term trends, the Federation foreign trade seems to have increased in the first quarter of 1999. By contrast, the fallout of the Kosovo crisis on the RS has meant a dramatic drop in both imports and exports to the FRY, although the fall in imports from the FRY has been mitigated by increased imports from other origins (Tables 7-9).

⁸ We are reporting RS statistics 'as is' even though serious doubts remain about data integrity.

⁹ Even without counting 'illegal (unrecorded) imports.

¹⁰ EBRD, in "BiH 1999 Country Profile" (March 1999) reports a Balance of Trade deficit for 1998 of US\$ 1,643 million.

¹¹ The Bulletin of Central Bank of BiH (No1.-1999) publishes a Balance of Payments table. Though covering only two months for the Federation (Jan-Feb 1999) and 3 months for the RS (Jan-March 1999) the trade data – when extrapolated (hypothetically) to the whole of 1999 – would imply a trade balance deficit of US\$ 2,480 million in 1999.

Table 7: Foreign Trade (BiH) (million US\$)

Period	Exports Total	Imports			
		Total	EU	CROATIA	SLOVENIA
1997	372	2,377	943	713	317
1998	491	2,508	1,025	740	350
Q1-97	68	609	215	177	73
Q2-97	89	563	238	157	83
Q3-97	107	582	232	192	77
Q4-97	108	624	258	187	85
Q1-98	106	530	219	154	69
Q2-98	110	589	250	171	78
Q3-98	143	669	255	222	95
Q4-98	132	720	302	194	108
Q1-99	N/A.	N/A.	N/A.	N/A.	N/A.

Source: Direction of Trade Statistics (IMF)

Table 8: Foreign Trade (Federation) (x1000 US\$)

Period	Exports TOTAL	Imports				Imports (x1000 KM)
		TOTAL	EU	CROATIA	SLOVENIA	
1997	108,683	1,544,970	685,717	295,935	211,664	2,922,680
1998	185,264	1,193,172	403,986	301,025	168,177	3,515,052
Q1-97	17,600	183,948	64,579	34,233	29,295	596,905
Q2-97	25,503	594,788	299,072	104,034	73,357	717,851
Q3-97	27,206	377,596	160,514	82,390	51,996	788,051
Q4-97	38,374	398,638	161,552	75,278	57,016	819,873
Q1-98	47,588	315,588	84,849	102,905	43,501	682,616
Q2-98	11,143	135,790	76,489	15,094	16,972	819,391
Q3-98	27,198	335,199	113,883	84,148	47,833	920,395
Q4-98	99,335	406,595	128,765	98,878	59,871	1,092,651
Q1-99	68,851	324,941	95,755	92,070	50,523	728,874

Source: Federal Institute of Statistics (USD figures)

Source: CAFAO (KM figures; derived for customs evidence)

Table 9: Foreign Trade (RS) (x 1,000KM)

Import from:	Jan - Apr 1998	Jan - Apr 1999	Apr 1999	May 1999
Greece	3,878	3,783	852	951
Bulgaria	4,472	5,031	883	654
Hungary	9,400	31,644	10,908	15,123
Yugoslavia	288,203	130,288	24,225	21,878
Croatia	4,307	10,455	2,620	4,761
Slovenia	16,560	44,164	10,527	15,675
Italy	7,850	15,289	4,711	6,144
Germany	16,426	22,052	(*)	(*)
Other countries	29,697	64,936	8,822	7,867
TOTAL	380,793	327,640	63,547	73,053

Table 10: Foreign Trade (RS) (x 1,000KM)

Export to:	Jan - Apr 1998	Jan - Apr 1999	Apr 1999	May 1999
Greece	1,325	692		
Bulgaria	55	9		
Hungary	272	47		
Yugoslavia	130,737	33,684	3,238	7,303
Croatia	341	758	340	284
Slovenia	1,615	2,779		
Italy	4,691	5,764		
Germany	3,680	5,131		
Other countries	19,490	42,774		11,225
TOTAL	162,205	91,638		18,812

Notes:

(*) Germany included in 'other countries'

Table 11: Current Account

(x1000 KM)

Category	Federation Jan-Feb 1999	RS Jan-Mar 1999
Exports (goods)	69,400	92,200
Imports (goods)	333,400	331,200
Balance of Trade	-264,035	-239,019
Services (net)	-77,800	-7,335
Current transfers	-3,126	20,910
Current Account	-320,925	-249,480

Source: CBBH, Bulletin No1-1999.

IV. Labor Market

Population and labor market data are no better than the statistics on foreign trade. The “true” unemployment rate is hard to calculate since, in the absence of a census and household surveys, both the numerator and denominator are guesses, at best.

The Federal Institute for Statistics estimates the Federation population at 2,243,789 (as of December 31, 1998), and the latest bulletin of the RS Statistical Institute estimates the RS population at 1,448,537. Accordingly, the BiH official population is estimated at 3.69 million, compared to UNHCR’s 1997 estimate of 3.9 million.

In order to calculate the unemployment rate, the economically active population needs to be known. In 1991, the active population was 40.7% of the total population. This percentage is below rates observed in OECD countries. Assuming the percentage of the economically active population is the same as the level observed in 1991, using published data and making assumptions about “waitlisted” employees (which is equivalent to underemployed or unemployed workers) we arrive at the following estimate of the unemployment rates (see the following graphs).

Category	Federation	RS
(1) Active population	913,222	589,555
(2) Employed	340,755	121,555
(3) Unemployed and waitlisted ¹²	278,697	186,000
(4) Self-employed, farmers and hidden unemployment	293,772	282,000
Apparent unemployment rate (3)/(1)	30.5 %	31.5 %

How does the labor market function? Evidence is mixed. In the Federation, employment (after filtering out the waitlisted) increased by 14.7% between January 1998 and January 1999. Since in 1998 GDP increased by an estimated 19%, for every one percent increase in output, employment increased by 0.77 %. This elasticity compares favorably with the average elasticity observed in the OECD area (0.52).

How rigid is the labor market? The following four observations point at labor market rigidities:

- net wages continued to increase significantly in spite of the high unemployment rate (even though one may rightly wonder how representative reported ‘net wages’ really are).

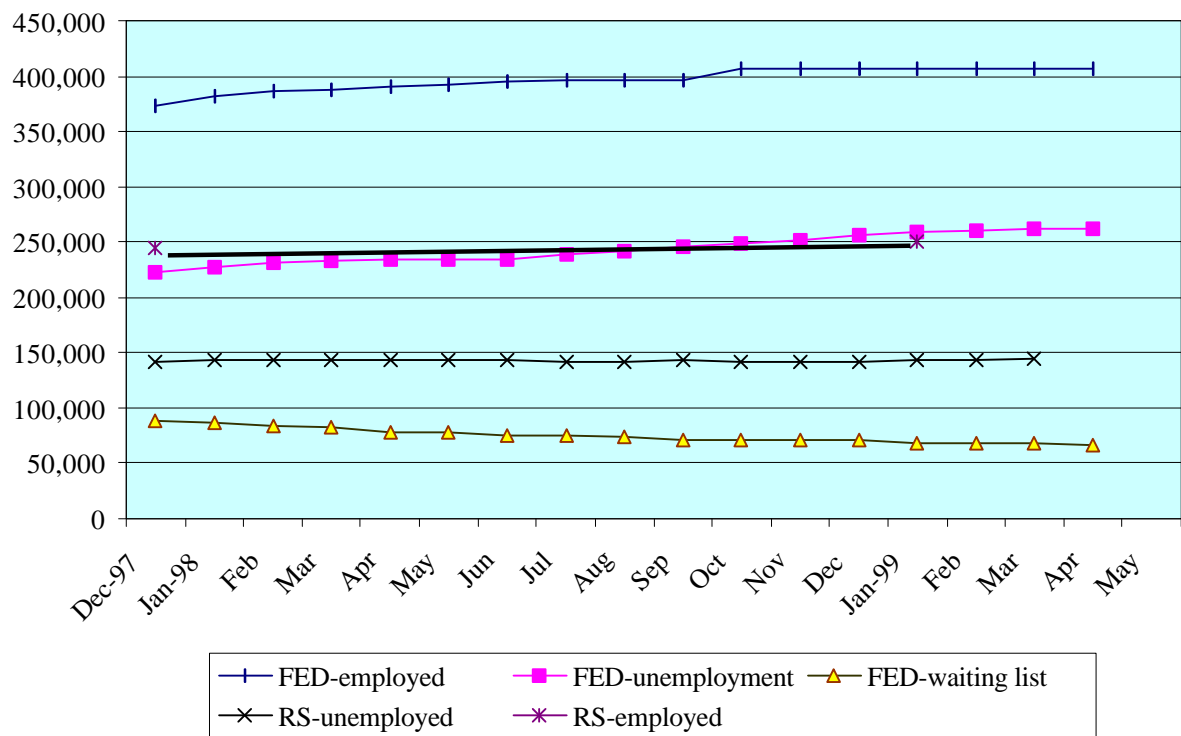
¹² The Federation Statistical Institute categorizes ‘waitlisted employees’ under ‘employed’. For the purpose of the calculation of the unemployment rate we have re-categorized waitlisted under Unemployment.

- sectoral differences in net wages are not large, the sector with the highest net wages is only double the net wages in the lowest-paying sector¹³
- regional differences in net wages paid out are also not large; in the Federation, net wages in the Canton with the highest average is only 50% higher than in the Canton with the lowest average net wages.
- reported net wages paid to the public administration exceed average net wages paid.

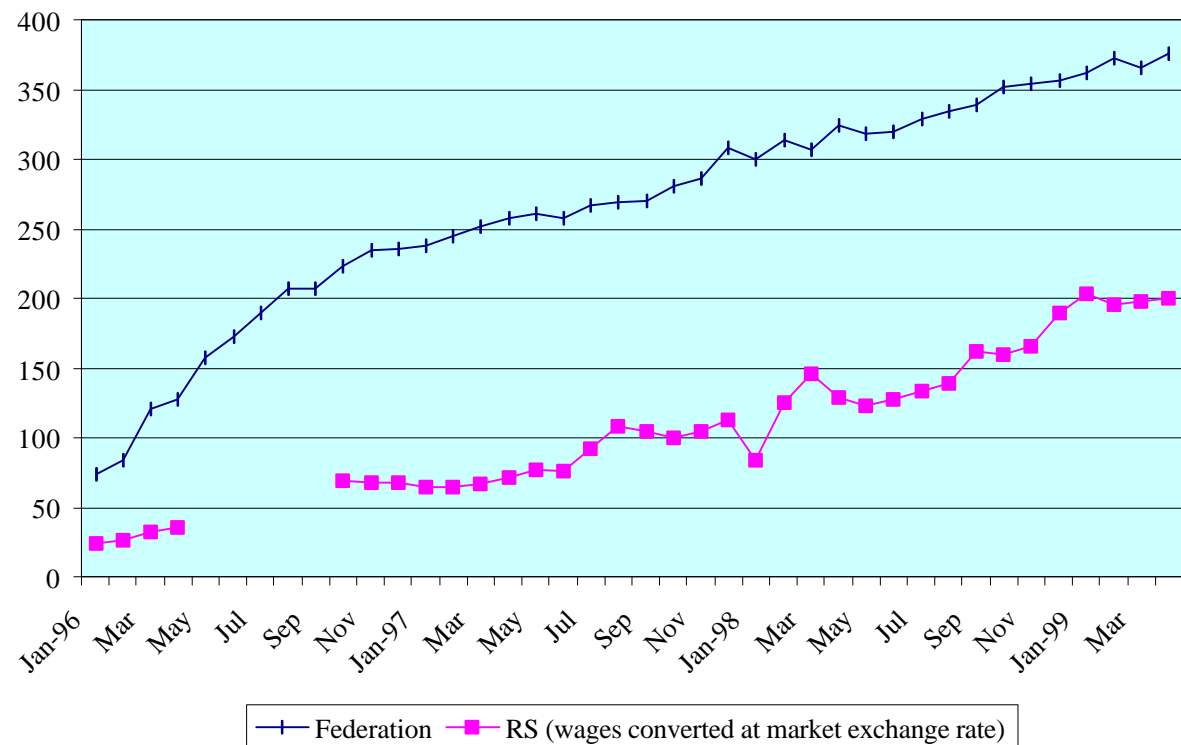
Another cause for worry is the situation of the pension funds. The low employment ratio implies that for every pensioner (Federation) only 1.54 employees (including the waitlisted) are contributing into the pension fund. Reportedly, the pension payments are now several months in arrears.

¹³ This contrast with, for instance, Thailand, a country characterized by a highly flexible labor market. Industrial Census data show that labor income in the highest-paying sub-sector is almost seven times as high as the average industrial sector labor income, while the highest-paying sector pays out a labor income of almost forty times the labor income paid in the lowest-paying sector.

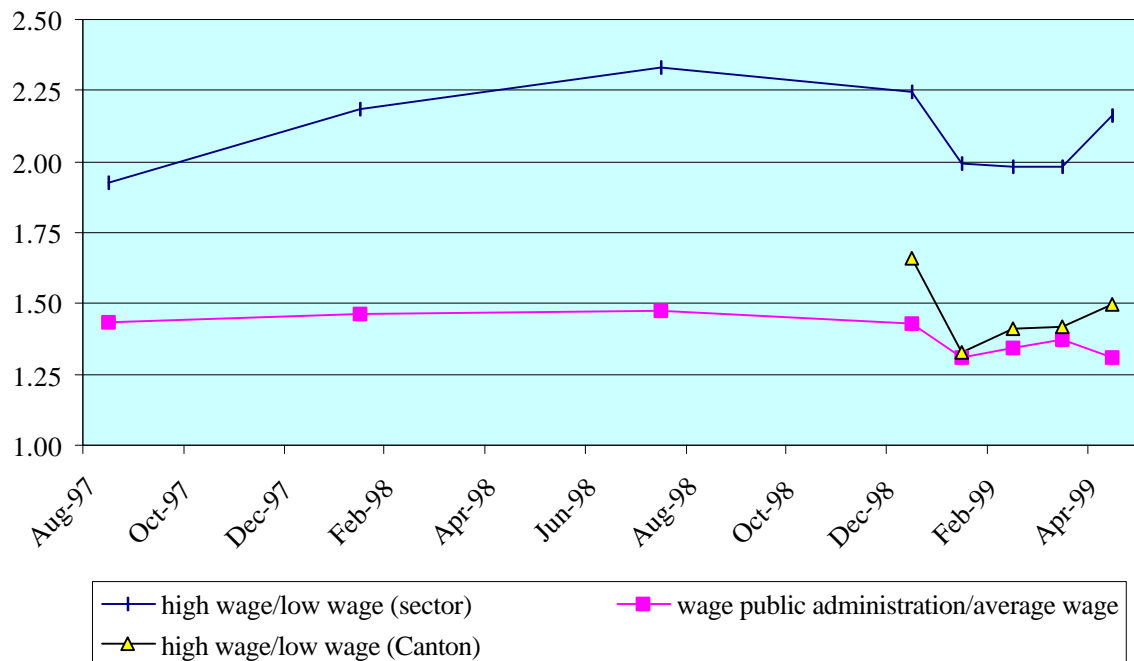
EMPLOYMENT SITUATION



MONTHLY NET WAGES (KM)



LABOR MARKET : NET WAGES FORMATION (FED.)



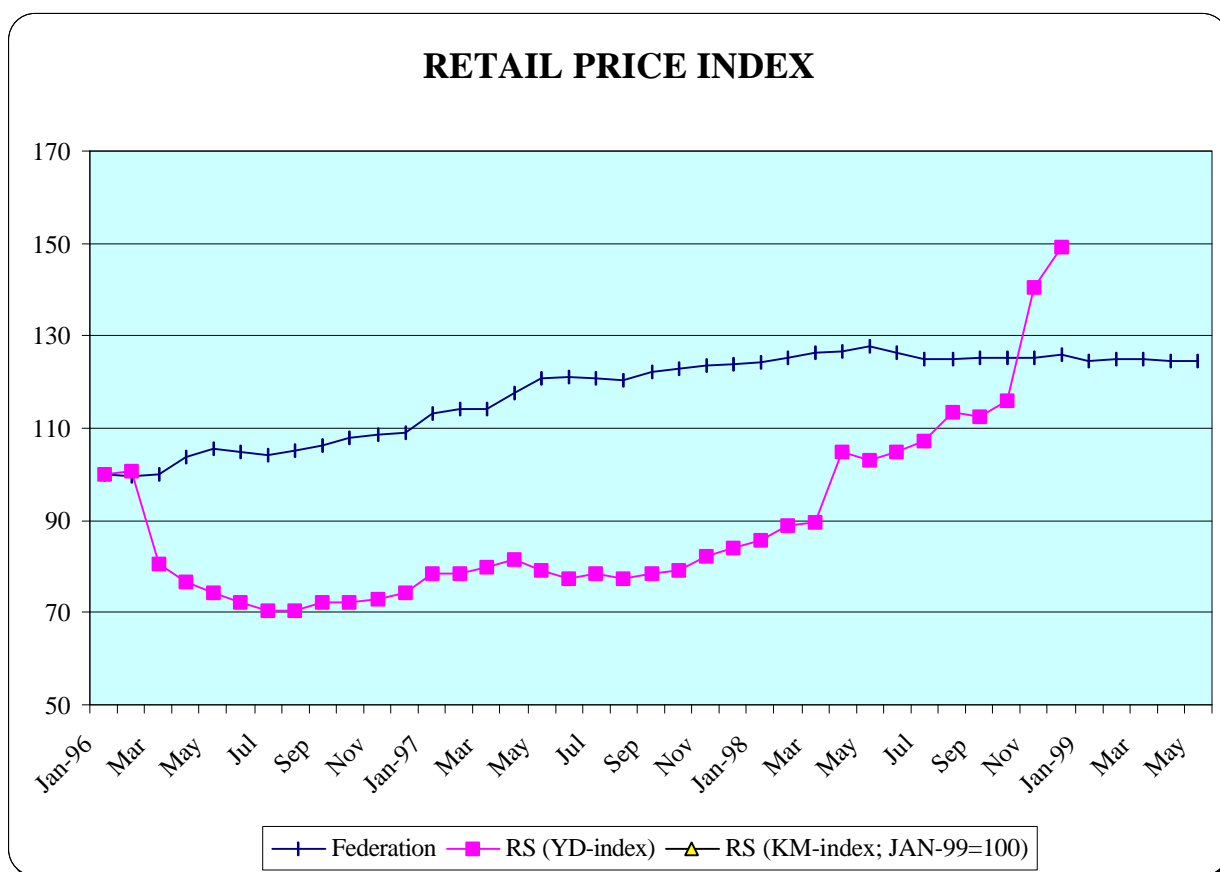
PENSIONS (FEDERATION)



V. Prices, Wages and Exchange Rates

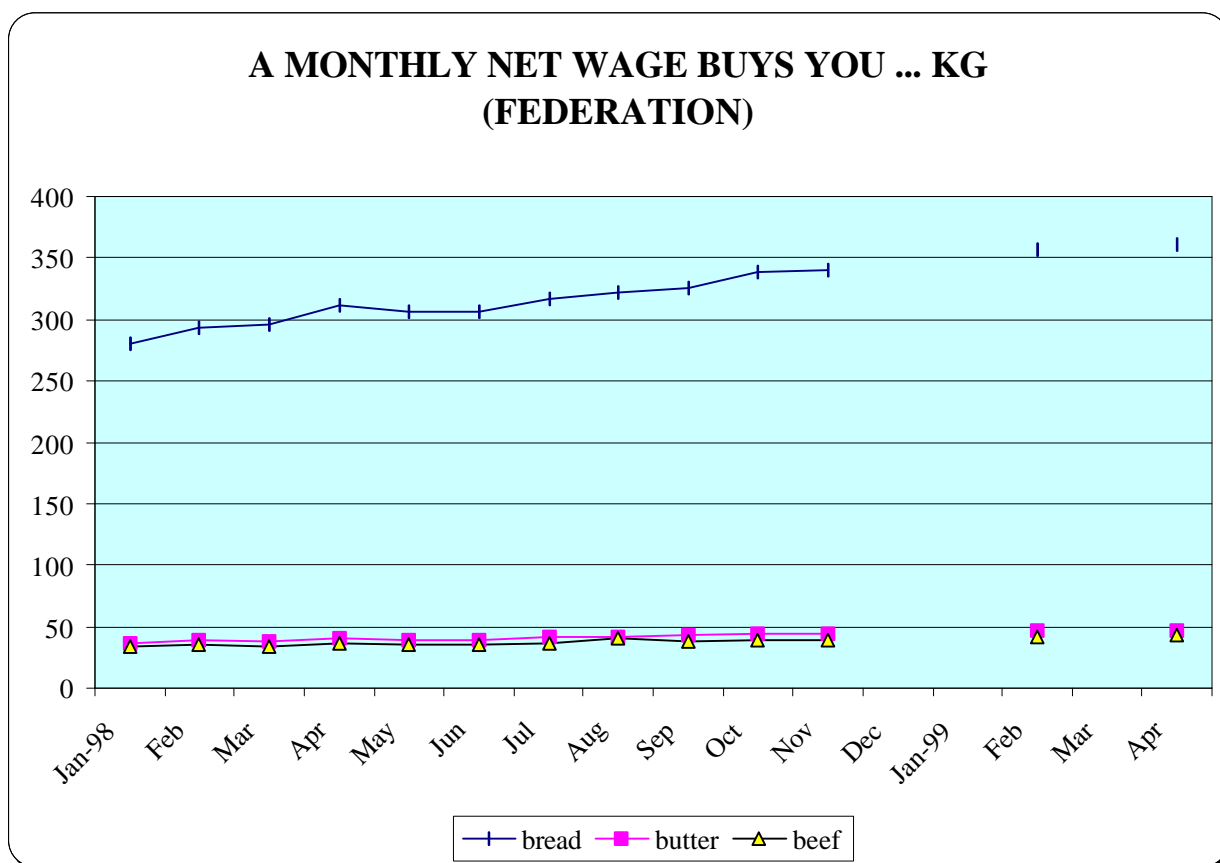
After a price inflation of over 12% was recorded in 1997, inflation has continued to decelerate in the **Federation** during 1998 by 5.1%. This trend continues into 1999 with retail prices actually falling marginally.

By contrast, the average price level in the **RS** increased by 38% compared to 1997. However, this inflation was calculated on the basis of an index expressed in Yugoslav Dinar (YD); when inflation caused by the depreciation of the Dinar is taken out, inflation was actually less dramatic. Since the start of 1999, the RS Institute of Statistics computes the retail price index based on the new BiH currency, Kovertible Marka (MK), prices rather than YD. Nevertheless, if the price trends currently observed in the RS continue, price inflation for 1999 could reach the double digit levels. That said, nominal prices in the Federation when compared to the RS, are still low.



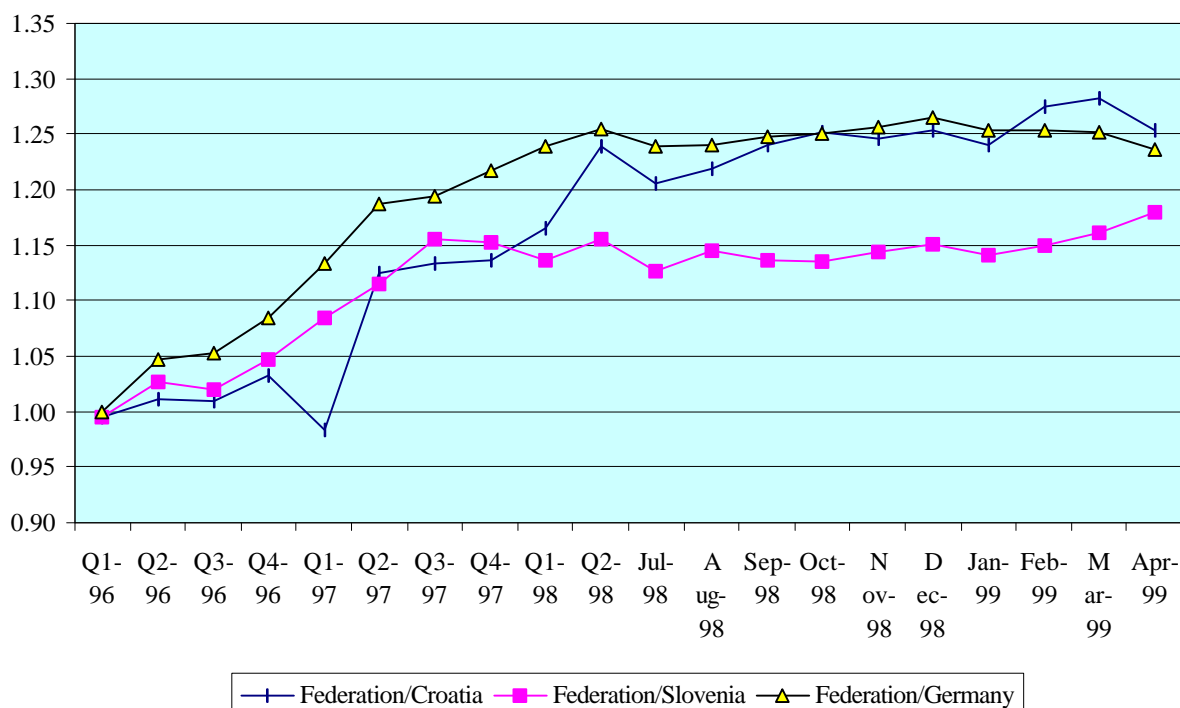
Wages and Purchasing Power

Instead of constructing a **real** net wages index, we calculated what an average monthly net wage could buy. In the Federation it can buy 361 kilogram (kg) of bread, or 47 kg of butter, or 42 kg of beef. This is a significant increase in purchasing power compared to January 1998 when the monthly net wage bought 280 kg of bread, or 37 kg of butter, or 33 kg of beef.



In the RS, the average monthly net wage (expressed in YD) paid out in December 1998, bought 284 kg of bread, 14.5 kg of butter or 18 kg of beef. These figures demonstrate the lower wage earned in the RS, as well as the different relative prices compared to the Federation.

BILATERAL REAL EXCHANGE RATES



Exchange Rates

The April issue of *BiH Economic Update* introduced the Federation Real Effective Exchange Rate (REER).¹⁴ The real exchange rate affects the level of imports and exports. If the real exchange rate depreciates, then imports become less attractive to BiH citizens, and BiH exports become more attractive to foreign countries. If the real exchange rate appreciates, then the reverse is true. Because the nominal exchange rate of the BiH KM is fixed against the German Deutsche Mark (DM), BiH authorities cannot manipulate the real exchange rate. The real exchange rate thus depends on the differential price trends only. The April issue demonstrated that the REER had undergone little change since early 1997. This section shows bilateral real exchange rates (RER) with Croatia, Slovenia and Germany. The graph demonstrates that the currency appreciated (in real terms) against the Slovenian Tolar until Q3-97, against the Croatian Kuna until Q2-1998 and against the DM until Q2-1998. RERs remained virtually unchanged thereafter.

The REER being a relative concept (i.e., it measures trends in exchange rates) rather than absolute differences in purchasing power, we constructed a *butter exchange rate*.¹⁵ Like the UK magazine's (The *Economist*) hamburger case, butter is very much a standard commodity in BiH. If purchasing power parity holds, then one dollar should buy as much butter in London as it does in Sarajevo. But does it?

¹⁴ The real exchange rate of the BiH KM versus the currencies of the Federation's trading partners.

¹⁵ Not unlike the "hamburger" methodology applied by 'The Economist' to calculate cross-country differences in purchasing power.

In November 1997, one kilogram of New Zealand butter in the London international commodity market cost US\$ 3.22. In the Federation retail market, butter sold at the *equivalent of* KM 8.02 per/kg. The implied purchasing power parity exchange rate would thus have been KM 2.49/1 US\$, whereas the market exchange rate actually stood at KM 1.7555 – 1 USD (November 1997), an indication that the KM was overvalued. But obviously, a retail price is not the same thing as a wholesale price. Adding a 25% retail margin plus 5% sales tax would bring the international price of butter (to arrive at the retail market) up to KM 1.9156, still an indication that the KM was overvalued. How has the butter purchasing parity (inclusive of margins) evolved since November 1997? Actually very little: 1.9369 in February 1998, 1.9778 in May 1998, 1.9109 in August 1998, and 1.8644 in November 1998. Interestingly, today's nominal exchange rate is more in line with the rate calculated using purchasing power parity index.

VI. Fiscal Indicators

The government system of BiH is decentralized, which complicates statistical data collection. Economic responsibilities of the state government are limited to areas of foreign trade policy, external debt servicing, customs policy and monetary policy (i.e., the Central Bank, which operates as a currency board). Entity governments are in charge of areas not specifically assigned to the State. Furthermore, in the Federation, substantial power is devolved to the 10 Cantons, where the Cantonal administrations are responsible for public services, education, social transfers and other matters.

The government is prohibited from taking credits from the Central Bank, or borrowing from the public or commercial banks, as that would violate the rules of the currency board, and IMF agreements. The government is thus constrained by tax and non-tax revenue, in addition to foreign loans and grants. Whenever a revenue shortfall is anticipated, budgetary expenditure needs to be revised downward.¹⁶

Public expenditures in the 1996-1998 period averaged 62% of GDP. The provision of large amounts of donor funding has facilitated this large public expenditure program while enabling BiH to maintain fiscal stability. The present level of government spending, as a percentage of GDP, is excessive. A major effort must be undertaken to enhance revenue mobilization by widening the tax base rather than by raising tax rates, reducing public spending, improving expenditure management, re-balancing recurrent expenditures, or restructuring the Social Security System.¹⁷

As the government cannot have recourse to domestic borrowing, the focus is on tax revenues (Tables 11 and 12). CAFAO's data indicate a drop in revenues in the Federation during the first quarter of 1999 (a decrease of 19.4% compared to the fourth quarter (Q4) 1998, and – 7.3% compared to Q1-98). In the RS, similar falls have been observed (respectively –32.4% and –19.1%) during Q1-99. In the Federation, the shortfall is caused by lower customs duties and (import) excises revenues, whereas in the RS lower customs duties and sales tax revenues caused the shortfall.

¹⁶ The Federation government accumulated KM 147 million of unpaid expenditures (arrears) in 1998. While the IMF conditionality requires that there be no budget arrears, the Federation would like to honor these unpaid expenses should revenues improve. The proposed 1999 Federation Budget planned KM 920 million of expenditures. Proposed amendments and unpaid expenses carried-over, bring the budgetary need to KM 1,162 million. On the other hand, it now seems unlikely that tax and non-tax revenue will reach the targeted KM 855.8 million for 1999 (up from the actual 780 million of revenue for 1998). As a result, budgetary shortfalls are forecast ranging from KM 253 million to KM 321 million.

¹⁷ See "1996-1998 Lessons and Accomplishments : Review of the Priority Reconstruction Program and Looking Ahead Towards Sustainable Economic Development (A Report Prepared for the May 1999 Donors Conference).

Table 12: Consolidated Public Revenue in the Federation (1998)**(x1000 KM)**

Description	Federation	Canton	Municipality	Total	%
Revenues (I-IV)	778,032	1,274,145	315,576	2,367,753	100
I-Tax revenues (1-4)	42.86%	67.72%	45.71%	1,340,491	56.61
1. Salary taxes	-	13.60%	11.49%	210,978	8.91
2. Income taxes	1.33%	5.26%	2.67%	85,753	3.62
3. Sales taxes and excises	41.52%	48.53%	28.59%	1,031,662	43.57
4. Property, gift/inheritance & other taxes	-	0.33%	2.51%	12,098	0.51
II-Non-tax revenues (5-7)	41.53%	24.18%	21.54%	699,197	15.55
5. Revenues from fees and penalties	-	2.72%	6.97%	368,188	15.55
6. Revenues on special regulations	40.05%	4.05%	14.57%	109,190	4.61
7. Contributions for :		17.41%		221,819	9.37
7.1. Health care		15.79%		201,171	8.5
7.2. Education, culture and sport		1.62%		20,648	0.87
III-Capital revenues	0%	3.32%	19.94%	105,194	4.44
IV-Other revenues	15.61%	4.79%	12.81%	222,871	9.41

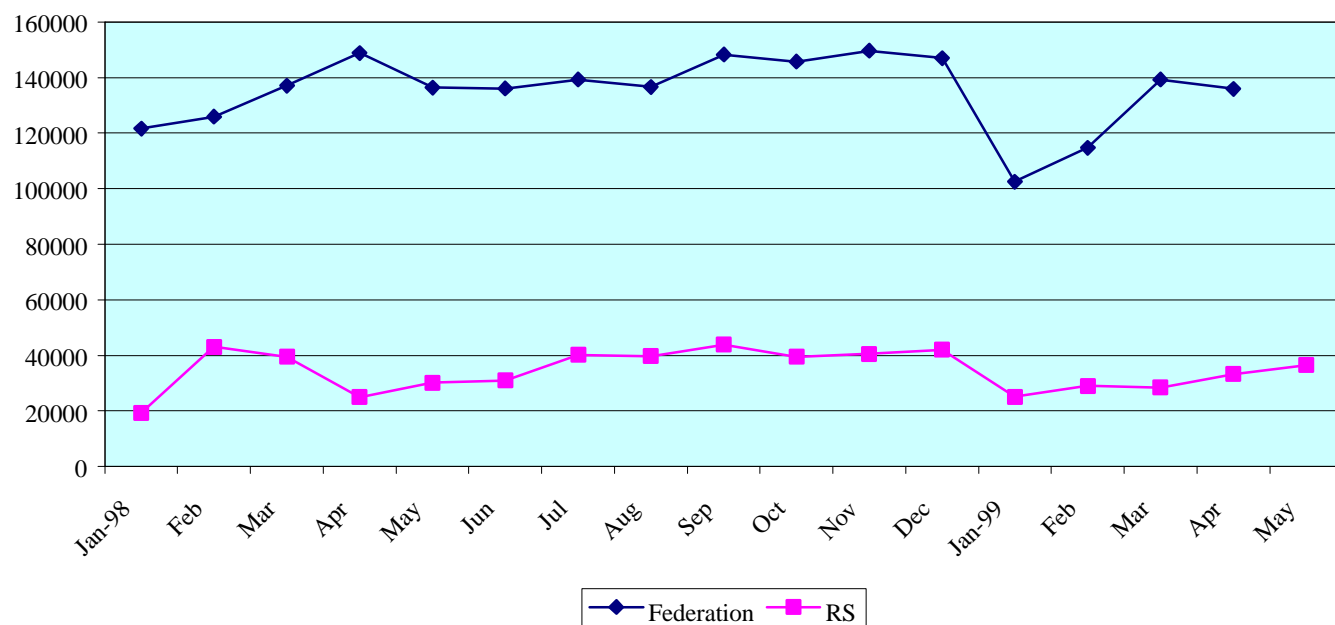
Source: adapted from Dr. Vojimir Radoicic (Institute for Economic and Organization)

Table 13: Public Revenue in the RS (1998) (x1,000 KM)

Description	Amount	%
Revenues (I-IV)	494,232	100%
I-Tax revenues (1-5)	312,085	63.10%
1. Salary taxes	33,074	6.70%
2. Income taxes	8,690	1.80%
3. Sales taxes, excises, customs	231,158	46.80%
4. Special tax for financing Army of RS	24,055	4.90%
5. Railroad taxes	15,073	3.00%
6. Property, gift and inheritance taxes and other taxes	35	0.00%
II-Non-tax revenues (7-8)	133,003	26.90%
7. Revenues from fees and penalties	81,313	16.50%
8. Revenues on special regulations	51,690	10.50%
III-Capital revenues	1,207	0.20%
IV-Other revenues	47,846	9.70%

Source: adapted from Nenad Racic (Ministry of Finance of RS)

TAX REVENUE (Source : CAFAO)



VII. Monetary and Financial Sectors

Since the establishment of the Central Bank of BiH¹⁸ in August 1997, substantial progress has been achieved in promoting the use of the KM. The currency board has definitely contributed to relative price stability in the segment of the Federation where the KM is widely used. One could claim that the currency board arrangement restricts commercial banking development. However, the technical insolvency, undercapitalization and inadequate commercial or retail banking are more serious constraints, as is the existence of the socialist payment bureaus.

According to Entity bank privatization laws, all socially-owned banks in BiH will be privatized or liquidated, if insolvent, by 2000. In order to avoid liquidation and/or formal privatization a wave of bank mergers and recapitalization is observed (in the Federation, this is due, in part, to the provisions of the commercial banking laws that doubled the size of net capital from KM2.5 million to KM 5 million as of April 23, 1999). Restructuring of the financial sector in both entities is anticipated to lead to a reduction in the number of banks from the initially 21 socially owned and 51 private banks to about 15-20 stronger banks.

Banks have yet to overcome depositor skepticism caused by citizens' experiences with hyperinflation and the loss of foreign exchange deposits as a result of the 1992-95 civil war, as well as to diversify their services and adopt a rational fee structure. Introduction of a deposit insurance agency and one or more foreign banks in each entity would enhance the public's confidence in the BiH banking sector (Tables 13).

Term lending is funded almost exclusively from donor credit lines, at attractive interest rates linked to London Interbank Offer Rate (LIBOR) e.g., USAID's Business Finance (BF) program. Interest rates for short-term loans are high, though they have apparently come down since December 1997, and are subject to large variances. The high rate on short-term loans reflects the scarcity of capital and the risk of default (Table 14).

According to data released by the Central Bank, the money supply (M1) totaled KM 1,237 million at the end of 1998, or 18% of nominal GDP. On the other hand, the broad money supply (M2) was equivalent to 22.4% of GDP. The first is an indication of the low velocity of the BiH economy, the second is an indication of restricted supply of and/or demand for financial savings instruments of the present banking sector. Most deposits at commercial banks are held by registered businesses.

¹⁸ Under the June 1997 Law on the Central Bank of Bosnia and Herzegovina, the Central Bank will operate as a currency board for the first six years of its existence, issuing the new domestic currency (KM) at the fixed exchange rate of 1 KM – 1 DM. During this six-year period the CBBH is restricted from engaging in the extension of credit through the creation of money. The CBBH may impose reserve requirements against KM deposits at commercial banks. Broad money supply expands in connection with foreign financing and private inflows.

Table 14: Monetary and Financial Sector survey**Million KM**

End-of-period	Broad Money (M2)	Money (M1)	Commercial Banks Claims on the Economy		
			BiH	Federation	RS
30.09.97	971	755			
31.12.97	1178	926	2306	1764	538
31.03.98	1166	931	2603	1845	757
30.06.98	1140	938	2576	1852	723
30.09.98	1321	1074	2624	1848	776
31.12.98	1547	1237	2808	1906	901
31.01.99	1544	1242	2837	1917	920
28.02.99	1492	1174	2757	1954	803
31.03.99	1510	1178	2712		

Source: Central Bank

Table 15: Lending Interest Rates (Annual %)

Bank	Short-Term Credits	
	Minimum	Maximum
BH banka Sarajevo	19.56	28.46
Gospodarska banka Sarajevo	18	30
Komerc banka Tesanj	24	42
Komercijalna banka Tuzla	8.17	40.27
Market banka Sarajevo	12	36
Postanska banka Sarajevo	20	30
Tuzlanska banka Tuzla	32.32	52.9
Universal banka Sarajevo	19	37.67
Union banka Sarajevo	12.68	23.58
UPI banka Sarajevo	14	26.8
Central Profit banka	15	20
Commerce banka Sarajevo	25	34.66
Gospodarska banka Mostar	8.4	18
Hrvatska postanska banka Herceg-Bosna	9	24
Agroprom banka	12	18
Kristal banka	12	18

Source: CBBH.

VIII. Privatization

A. FEDERATION OF BOSNIA AND HERZEGOVINA

Citizen Accounts Opened in the Federation. Unique Citizen Claim Accounts have been opened for 1.8 million people and initial account statements were mailed on May 7. Distribution of Unique Citizen Accounts throughout the Federation took 25 days. For those who did not receive a statement in the mail, they may go to the Federation Payment Bureau of their choice and complete the Z1 form requesting the account statement. Statements should be available in the Payment Bureau at the end of July when the Claims Registry Transactions system is activated. Those having received their statements may begin to file appeals with Federation institutions for corrections to account balances.

Auctions Begin. Small-scale privatization has begun. Six Cantons have published Registers of Auction and Tender Items, including approximately 5,000 items in total (assets, parts, enterprises as a whole, and municipal business premises) for sale through small-scale. Only four Cantons (Tuzla, Sarajevo, Zenicko-Dobojski and Bosansko-Podrinjski Canton) have published complete Registers of Auction and Tender items to date.

Auctions and/or tenders began in Sarajevo, Tuzla and Zenicko-Dobojski Cantons during the second half of June. The Sarajevo CPA conducted the first successful auction on June 7. The Sarajevo and Zenica CPAs have completed the public opening of tender bids and the public announcement of the top five bidders. Determination and announcement of the winners of these tenders are imminent. All sales through small-scale require 35% of the final purchase price to be paid in cash, whereas the remaining balance of 65% may be paid in claims.

Federation Enterprises are slow in Preparing for Public Offering. Preparation for Large Scale Privatization and the public offering of shares is underway. Enterprises are still in the process of completing revision of ownership transformation and Opening Balance Sheets. Although existing deadlines have passed, just over half of the 611 required revision reports are complete and less than 15% of 1,731 enterprises have submitted Opening Balance Sheets. Less than 5% of these enterprises have submitted their Privatization Programs. The Federal Agency for Privatization is expected to announce new deadlines for completion and submission of revision reports and Opening Balance Sheets in preparation for the Public Offering of Shares.

Also in preparation for the Public Offering of Shares, the Federation Securities Commission plans to issue licensing regulations for privatization fund management companies and privatization investment funds in early July.

B. REPUBLIKA SRPSKA

Cash Privatization Set to Begin in the RS. The first cash sales for enterprises that have state capital valued at less than 300,000 KM are right around the corner. The RS published its first sales announcements over the June 10/20 weekend. On July 26, the RS plans to auction five small enterprises in Banja Luka, followed by 4 small enterprises in Doboj on July 28. The next wave of auctions, expected in early August, should include about 15 more enterprises distributed among Bjeljina, Trebinja, and S. Sarajevo. In each sale, potential buyers will have the option of closing contracts with either cash or coupons linked to frozen foreign deposits. These initial sales will be followed with subsequent auctions throughout the summer. The RS plans to sell up to 100 small enterprises by early fall.

Preparations Continue for Voucher Registration. The RS continues to make preparations for its registration of participants. The new database of RS Citizens from the RS Ministry of Interior has been completed and delivered to the Directorate for Privatization (DFP). Following its completion of software development and hardware installation, the RS will begin a registration process to update all relevant information on participants, and to identify those eligible participants who have a demonstrated interest in participating in the privatization project.

Enterprise Preparation Continues. The DFP has developed partnerships with several independent institutions in the RS to perform a revision of internal shareholding for mixed-ownership enterprises. These institutions have been contracted by the DFP to review enterprise documentation on existing internal shareholdings. In total, documentation for over 180 enterprises has been transferred to these institutions for review. These institutions are wrapping up the first wave of reviews, and preparing for a second wave of close to 40 enterprises for which documentation is scheduled to be transferred in early July. The RS plans to complete share revision for an anticipated 400 enterprises with internal shareholding by the end of the summer. Following the completion of share revision, the DFP will shift its focus to receiving and approving Opening Balance Sheets and Enterprise Privatization Programs.

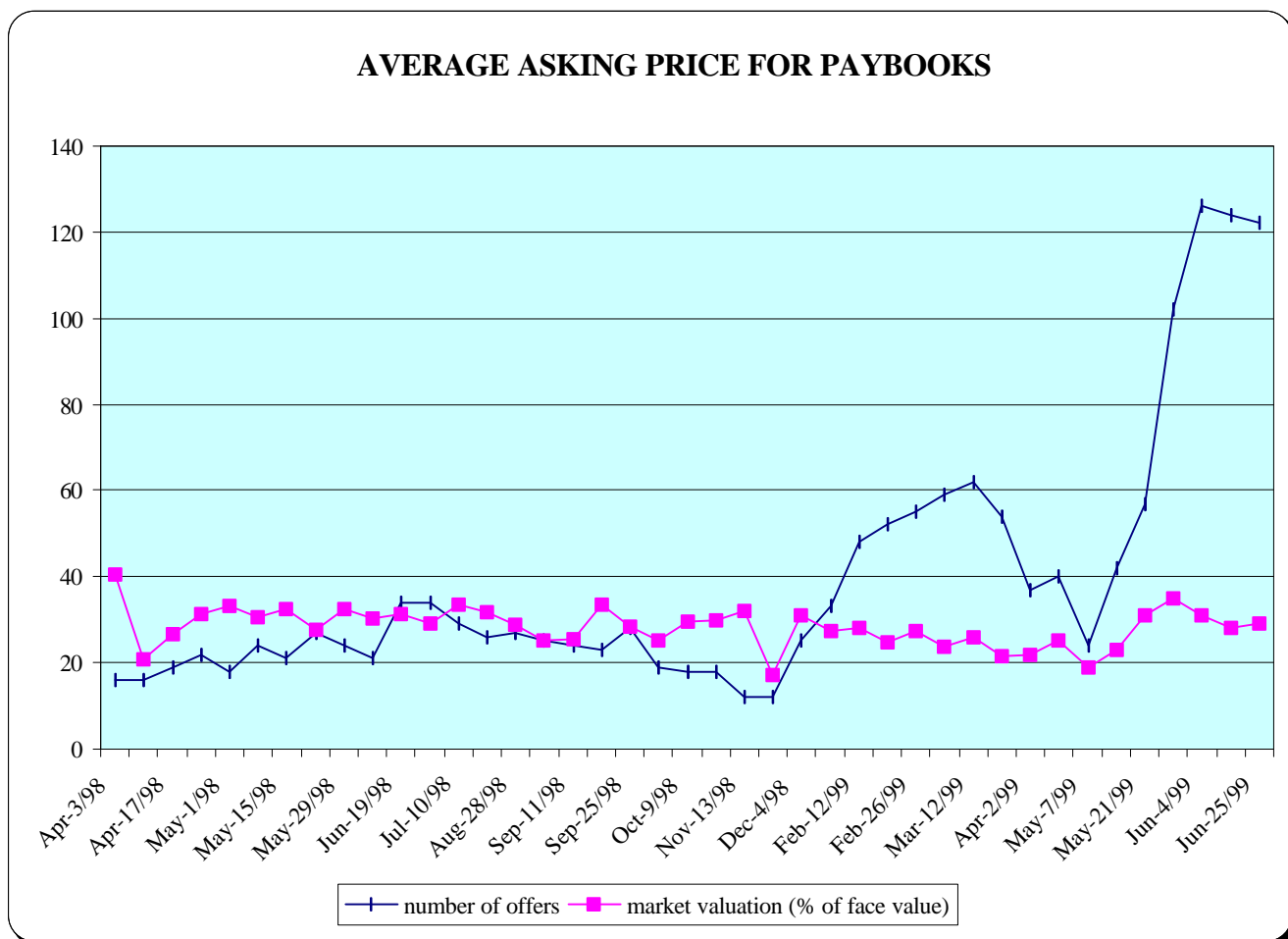
Appointment of Securities Commissioners Expected Any Day. The RS is expected to announce appointments to the Securities Commission any day. The causes for delay in appointing commissioners have been addressed, and the government has assumed responsibility to appoint provisional nominees. Once the commissioners assume their posts, important groundwork on market development can begin to support a Public Offering of Shares sometime in the year 2000.

C. TRADING OF CLAIMS

Financial assets that are being traded in BiH at present are claims that can be used to bid on assets in the Federation privatization process. Such claims that are known to be traded include soldiers' paybooks that were acquired during the war by former soldiers who have not yet been paid, and, frozen foreign currency accounts. Sellers of soldiers' paybooks or frozen currency accounts place advertisements in newspapers, in particular in the commercial weekly "Oglasi" published in Sarajevo (soldier's paybooks account for the vast majority of these ads). The ads usually quote the face value of the paybook and often quote an asking

price. The graph below shows: (a) the average percentage of face-value asked by sellers of paybooks since April 1998, and (b) the number of offers published.

The average asking price for paybooks continues to hover between 20 and 40%, averaging about 30%. However, with the actual privatization process now imminent, the interest of the public has increased sharply, as the rising number of offers demonstrates.



Payment Bureaus Transformation - An update

Bosnia and Herzegovina's Payment Bureaus were created in the mid-1950's to manage socially owned resources through control of the financial sector. In addition to collecting and distributing money, the Payment Bureaus perform numerous functions not related to payment services. These include tax collection; accounting, audit and treasury services for businesses and the government; and gathering and processing statistical information for the government. The various functions of the Payment Bureaus must be separated and moved to the private or public sector where they will support the new free market environment. This transformation of the Payments Bureaus' functions is also necessary to create a proper foundation for financial inter mediation and financial intermediaries. Allowing commercial banks to perform payment services is critical to developing sound financial institutions capable of mobilizing the Nation's savings. Mobilization of savings in support of domestic investment is the key to sustainable economic growth in BiH.

Update on activities:

1. In early 1999, entity officials and the international community agreed that the Payment Bureaus should be liquidated and their functions moved to other public and private institutions. A Blueprint strategy was drawn up to achieve this objective by the end of the year 2000.
2. Specific Blueprint goals include the following:
 - The development and implementation of standards to permit banks to provide payment services.
 - The abolition of overnight ceilings on cash holdings and the requirement that businesses deposit cash with the Payment Bureaus.
3. In February 1999, the international community established an Advisory Group to help and advise authorities in both entities on the implementation of the Blueprint and transformation strategy. The Advisory Group is chaired by USAID. Other members are the World Bank, International Monetary Fund, European Union, CAFAO, Office of the High Representative and the U.S. Treasury.
4. A full functional analysis of the Payment Bureaus was completed in June along with a Plan and timetable for removing the various functions:
 - The transfer of tax collection to the Ministries of Finance.
 - The transfer of Treasury functions to the Ministries of Finance.
 - The transfer of statistical functions to other institutions.
5. USAID provides funding for a full time Secretariat to coordinate functional and technical assistance from participating donors.

6. Amendments to the Law on Internal Payments have been adopted and approved by the Federation Cabinet and the House of Representatives on an emergency basis. These amendments allow for the controlled removal of monopoly powers of the Payment Bureaus in accomplishing payment transactions. These amendments also established a new corporate governance (Governing Board) over the Payment Bureaus with the specific authority to transfer the Bureaus' various functions to Government Ministries or private sector institutions where they will support a free economic market. The House of People should discuss these amendments at their next meeting.
7. The next step will be a financial verification of the existing assets of the Payment Bureaus in anticipation of these assets being redirected as the functions of the Payment Bureaus are moved to other institutions.
8. The Payment Bureaus employ approximately 2,800 people, many of whom are highly skilled in their fields. Most of these people will move to new institutions along with their functions. Those unable to find employment will be offered training to retool their skills and employment services. The donors will undertake a major effort to assess the unemployment problem and resolve these issues. This is the highest priority for the donors at this point.

The tax structure in BiH

This section describes the BiH tax structure, and compares the tax structure to international benchmarks.

Except for customs tariffs, tax rates (Table-1) differ between the Entities. Even the customs tax regime differed, until very recently. Basic customs rates are 0%, 5%, 10% and 15%.

Annex Table-1: Tax Rates and Special Provisions, in BiH and Selected OECD countries

	Federation	RS	USA	Japan	Germany	France
Sales Taxes/VAT (general rate)	20 %	18 %	no VAT	5 %	15 %	20.6 %
Corporate tax rate	30 %	10-20 %	35 %	38 %	45-30 %	33 %
Dividend relief	NO	NO (?)	NO	partial	full	full
Wages tax	15 %					
Personal income tax	0-25 %	0-25 %				
Top marginal rate of personal income tax	25 % 25 %	40 %	50 %	53 %	57 %	
Number of positive rates in personal income-tax schedule	3	4	5	5	N/A.	6
Social contributions (as % of gross wages)	45 %	42.5 %	21.4 %	26.3-41.6 %	32.3 %	42.9-44.8 %

Comments :

- The USA has no VAT; however, the consumption tax rate averaged between 8.7% and 6.2% from the 1960s to the 1990s.
- In the Federation and the RS, sales taxes are collected at retail level except excisable goods (at wholesaler level for imports and at manufacturer level for domestic products). Excises are collected on coffee, tobacco, beer, alcohol, non-alcoholic beverages, oil derivatives, imported cars (Federation), luxury products (RS).
- The corporate income tax is regressive in the RS; profits above KM 500,000 are taxed at 10%.
- Absence of dividend relief means that profits are taxed twice, once at the corporate level and once at the personal income level.
- No capital gains tax is applied in BiH.
- The OECD average corporate income tax is 33%.
- In the Federation, the basis for calculation of the wages tax is Gross wages less contributions.

- In the Federation, the basis for personal income tax is non-wage income; rates here are reported by CAFAO (July 1998) though another source reports 5-30% depending on type of income; reportedly (CAFAO), the Cantons can levy additional income tax up to 50% of the Federation rates.
- In the RS, personal income tax is 0% below KM 10,000 KM, 25% in the bracket of Km 10,000-15,000, and 20% in the bracket of KM 15,000-25,000, and 15% above 25,000 KM.
- In Japan the Social Contributions vary by industry.

Furthermore, the Federation Law about the Corporate Income Tax:

- Allows carrying forward of losses over a maximum of 5 years.
- Authorizes accelerated amortization is authorized for assets that reduce pollution, scientific and research work, education and training of staff.
- Reduces the corporate income tax by 100% in the first year of a new business, by 70% in the second year and 30% in the third year.
- Specifies (Article-13) that interest payments are counted as expenditures.
- Specifies (Article-28) that “the taxpayer who pays the taxable profit in his own productive activities” has his tax liabilities decreased for the total investment amount.¹⁹ The latter tax credit provision encourages investment out of retained profits.

The tax structure results in the following composition of tax revenue (Table-2) and tax burden (Table-3 and Table-4).

Table-2: Composition of Tax Revenues

	Federation	RS	USA	Japan	Germany	France
Income taxes	10.5 %	23.5 %	42.2 %	46.9 %	31.4 %	18 %
Social Contributions	30.3 %	20.2 %	29.8 %	27 %	37.2 %	40.1 %
Consumption taxes	53 %	55.7 %	14.7 %	13.5 %	26.7 %	27.1 %
Other	6.2 %	0.7 %	13.3 %	12.6 %	4.7 %	14.8 %

Source : OECD (for USA, Japan, Germany, and France)

Table-3: Tax Burden (as % of GDP)

	Federation-entity	OECD (1995)	OECD-Europe
General government tax revenues	58 %	35 %	42 %

¹⁹ However, there exists no provision that allows tax-free reserves to be built up.

Table-4: Government Revenues (excluding Social contributions) as % of GDP

	Federation-entity	middle-income countries		G-7 countries
		<i>Lower</i>	<i>Higher</i>	
Government revenue (excluding Social Security)	42 %	23 %	29 %	29 %

Note: G-7 includes Canada, France, Germany, Italy, Japan, UK, and USA

Conclusion:

1. The statutory corporate income tax rate (Federation) is close to the average rate applied in OECD countries. However, as no dividend relief is available, profits are taxed twice (at the corporate level and at shareholder level); the combined tax rate on capital thus exceeds 50% of gross profits (when local surcharges are added).
2. The wages tax rate is not excessive. However, the payroll tax is indeed high. The combined tax rate on labor thus exceeds 50% (of gross wages).
3. Customs tariffs are higher than in industrial countries²⁰, but below the tariffs applied by inward-looking developing countries.
4. The domestic Sales Tax rate is close to European VAT rates and higher than rates in the USA and Japan.
5. The resulting tax rates on labor and capital discourage production and encourage evasion and fraud. Along with the other impediments to doing business in BiH – making BiH a costly place to do business –, one understands that income taxes cannot contribute much to fiscal revenues. A reduction in tax rates (combined with stiffer, effective penalties for non-compliance) is even likely to result in higher fiscal revenues.
6. The characteristics of the BiH tax system imply that the total tax pressure (whether including or excluding payroll taxes), expressed as a percentage of ‘official’ GDP exceeds benchmarks in both the OECD countries and middle-income countries.²¹
7. Considering (a) the absence of dividend relief, and, (b) the tax credit for re-invested profits, investment out of new equity is penalized in favor investment out of retained profits.
8. In the Federation, the sum of the corporate tax rate and the capital gains tax rate (0%) exceeds the personal tax on interest income. Therefore, firms will prefer financing by debt rather than by retained earnings.²²

²⁰ By the end of 1999, tariffs on industrial products will average 3.8%, following developed countries’ commitments in the context of the World Trade Organization (WTO).

²¹ However, the tax burden may be overstated if the true GDP is significantly higher than ‘official GDP’.

²² As the tax structure favors debt-financed investments, the excess demand for loans is exacerbated.